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PICTET WEALTH MANAGEMENT

Switzerland Update

Lower rates and a stronger Swiss franc ahead

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FLASH NOTE

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SUMMARY

- At its latest meeting in June, the Swiss National Bank (SNB) decided to cut its policy rate for the second time this year, bringing it down to 1.25%. We expect one final rate cut in September, although it could come later.
- We continue to believe that the SNB will be reluctant to cut rates way below its estimate of the neutral rate, which is likely to be around 1%. For the SNB to cut rates below 1%, the bank would need to see the balance of risks to growth and inflation shifting to the downside.
- Swiss bond yields fell in the wake of the French election announcement and SNB meeting in June. But after reaching a low of 0.54% at the end of June, the 10-year Swiss government bond yield had rebounded to 0.65% by 8 July, after the French election.
- Taking into account the additional SNB rate cut that we now expect, we are lowering our year-end forecast for the 10-year Swiss sovereign bond yield from 0.9% to 0.7%. We therefore remain underweight Swiss bond duration because of the low yields on offer and because the inverted yield curve makes short-dated Swiss bonds more attractive.
- Investors' concerns over fiscal discipline in major economies are seen as supporting the safe-haven Swiss franc. In particular, continued political concerns in the euro area and the upcoming US presidential elections could give the currency a boost. The Swiss franc could hover between CHF0.94 and CHF0.98 relative to the euro in the next months.

ONE LAST CUT BY THE SNB

At its June meeting, the Swiss National Bank (SNB) decided to cut its policy rate for the second time this year, bringing it down to 1.25% (*chart 1*). The main

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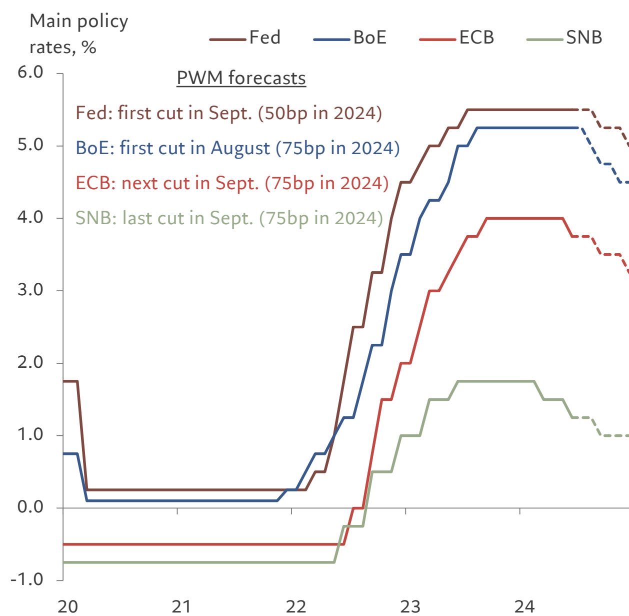
justification given was that "underlying inflationary pressure [had] decreased again compared with the preview quarter". **Crucially, the SNB's conditional inflation forecasts were revised lower by 10bp to 1.1% in 2025 and 1.0% in 2026, reflecting (somewhat) lower second-round effects** (*chart 2*). Since the SNB assumes stable policy rates in their projections, the forecasts would have been even lower without June's rate cut, providing another justification not to delay this decision. For now, **the SNB sees monetary conditions as "appropriate", but it left the door open for further easing if needed**. The weaker-than-expected June inflation print will probably also be seen as supporting the SNB's rate cut.

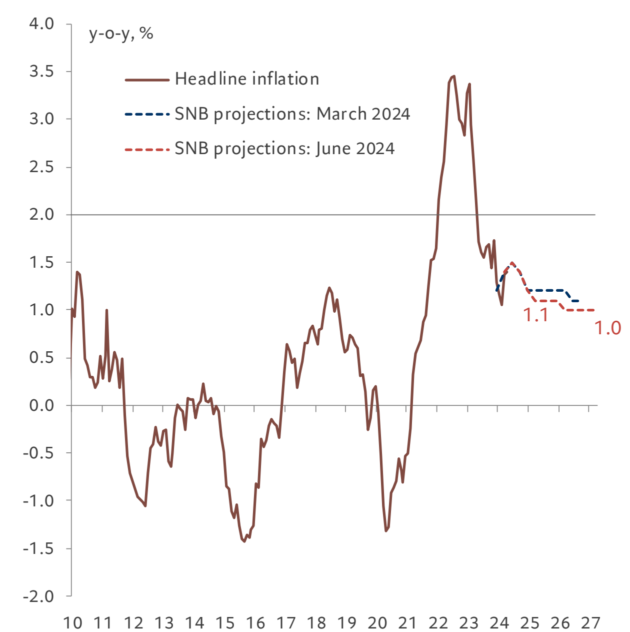
The SNB continues to expect a moderate recovery in the Swiss economy, with real GDP growth of around 1% this year, picking up to around 1.5% in 2025. However, downside risks from external demand and (geo-)political uncertainty have increased.

Chart 1: Policy rates and our projections



Source: Pictet Wealth Management, Refinitiv as of 08.07.2024

Chart 2: Swiss inflation rate and SNB projections



Source: Pictet Wealth Management, Refinitiv, as of 28.06.2024

To some extent, **the SNB's dovish messaging also reflects their concerns over currency appreciation**. The language on FX interventions was left unchanged in its June statement, with the SNB still "willing to be active in the foreign exchange market as necessary". But SNB chairman Thomas Jordan mentioned the "**very important role" of the exchange rate, adding that the SNB would use all its monetary policy measures" to ensure that inflation remains within the range consistent with price stability**". The SNB is likely monitoring the political situation in France and in the US very closely, and could intervene in case of excessive volatility and unwarranted tightening of the Swiss franc.

Looking ahead, we expect one final rate cut this year. Our base case is that this cut will come in September, but FX developments, policy decisions by other central banks (particularly in the US and the euro area) and inflation make the

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timing difficult to predict. Should inflation surprise to the upside over the summer, the SNB is likely to refrain from cutting rates again for longer. **We also maintain the view that the SNB will be reluctant to cut rates much below its estimate of the neutral rate, which is likely to be around 1%.** For the SNB to cut rates below 1%, it would need to see more downside risks to growth and inflation.

SWISS BONDS AS A SAFE-HAVEN

Already strong in 2023 (up 8% in CHF), seven-to-10-year **Swiss government bonds have again outperformed year-to-date**, posting a positive total return performance of 0.7% (on 8 July), while German and US bonds have posted a negative performance in local currency.

The divergence in the performance of US, German and Swiss government bonds—usually all considered as 'safe-havens'—has widened in the past couple of years (*chart 3*). The **10-year Swiss yield started to decouple from the 10-year German Bund yield in mid-2022**, when it became clear that much more subdued inflationary pressures in Switzerland than in the euro area would ensure that the SNB hiked rates less aggressively than the European Central Bank (ECB). After hiking its policy rate to a peak of 1.75% in June 2023 (compared to 4.0% for the ECB and 5.25-5.50% for the US Federal Reserve (Fed)), **the SNB surprised market participants by lowering its policy rate earlier than either, with the first Swiss rate cut coming in March**.

Market participants are now fully pricing in an additional rate cut from the SNB over the next twelve months (*chart 4*). They are even contemplating the possibility of more rate cuts over the medium term. The political uncertainty related to the snap election in France and the related strengthening of the Swiss franc drove the 10-year Swiss government bond yield down to 0.54% on 28 June, its lowest point this year. With the French elections now behind us, 10-year Swiss and German government bond yields have both rebounded (to 0.65% and 2.54%, respectively, on July 8).

Taking into account the additional SNB rate cut that we now expect, we are lowering our year-end forecast for the 10-year Swiss sovereign bond yield from 0.9% to 0.7%. Due to Swiss bonds' safe-haven status, we could see the 10-year yield decline lower than this in the autumn, towards 0.5%, as 2025 budget deliberations in the euro area could reignite political uncertainty. Nevertheless, we expect governments to reach some sort of agreement over the fiscal path ahead, paving the way for the 10-year Swiss yield to rise again towards our 0.7% year-end forecast. **We therefore remain underweight duration in the Swiss bond market because of low yields and because the inverted yield curve makes short-dated Swiss bonds more attractive.**

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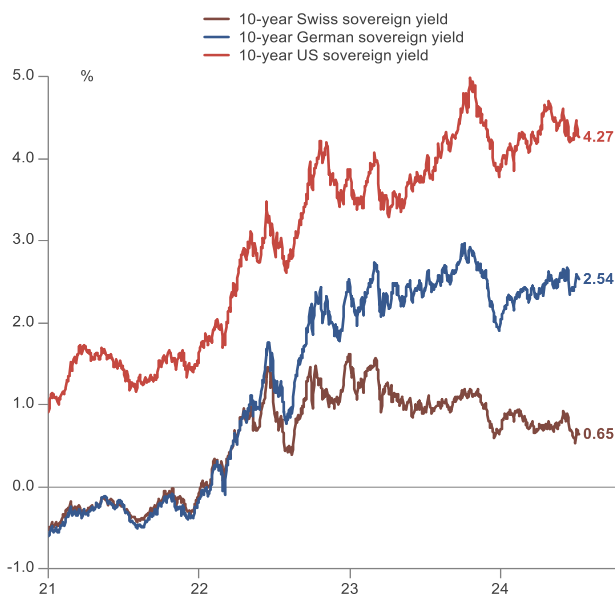
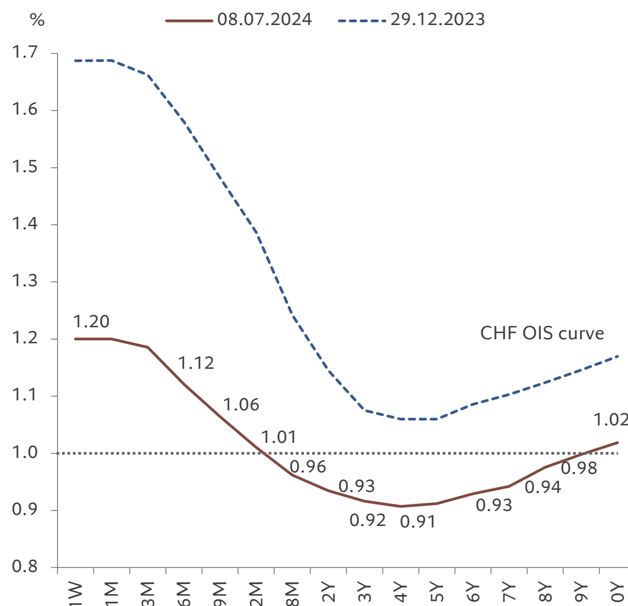
Chart 3: Swiss, German and US sovereign yields



Source: Pictet Wealth Management, FactSet, as of 08.07.2024

Chart 4: CHF overnight index swap (OIS) curve



Source: Pictet Wealth Management, Bloomberg Finance, L.P., 08.07.2024

FISCAL CONCERNS TO LIMIT CHF WEAKNESS

The Swiss franc has weakened since the start of the year as the SNB has shifted to a more accommodative stance. However, this trend may not last, as the monetary easing cycle in Switzerland is likely to prove shorter than elsewhere. What's more, the franc's sensitivity to interest-rate differentials tends to be volatile (*chart 5*). After all, the franc appreciated significantly in 2022 and 2023 despite a sharp deterioration in rate differentials.

Investors' concerns about the large volume of high-cost debt in major economies and ongoing fiscal slippage could increase. The hung parliament following the snap legislative elections in France and the upcoming US elections have heightened these concerns even more. **Because of tight fiscal discipline in Switzerland, the franc is seen as an attractive hedge against fiscal risks elsewhere** (*chart 6*).

The Swiss franc is sensitive to portfolio investment flows. While rising fiscal concerns could lead to higher foreign inflows and reduced Swiss outflows**, this supportive factor for the franc could be counterbalanced by continued global growth and low Swiss yields.**

Having reached our short-term target of CHF0.99 against the euro, we **see reduced downside potential for the franc given that fiscal concerns outside Switzerland are likely to be at the top of investors' minds in the coming months. Our base case is for the franc to trade in a range between CHF0.94 and CHF0.98 in the foreseeable future**, in keeping with our three-month projection of CHF0.97 (vs. CHF0.99 in our previous forecast) and year-end forecast of CHF0.95 (vs. CHF0.99 previously). Besides the search for higher carry, **we think that the Swiss franc's**

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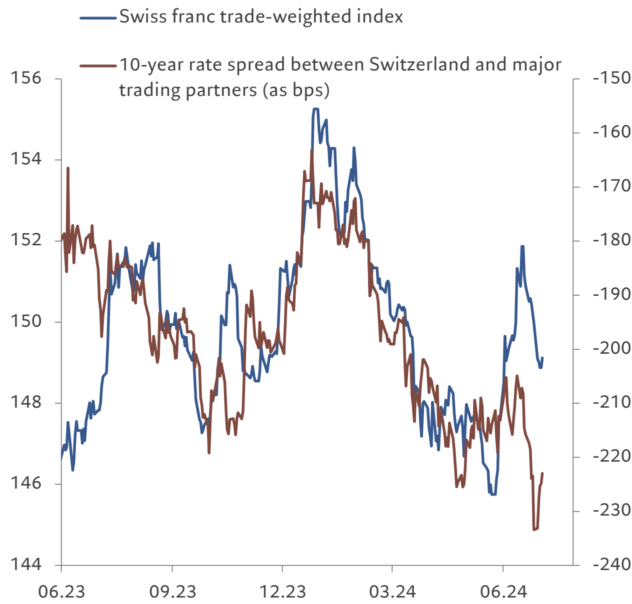
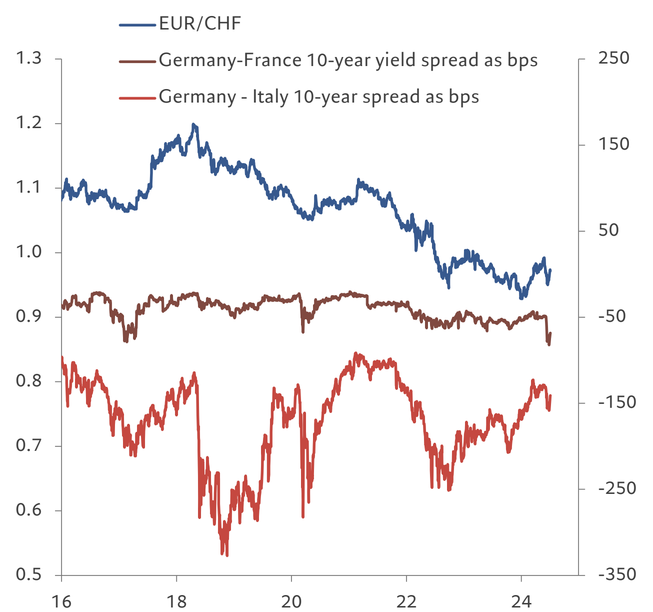
upside potential could be limited by possible SNB interventions in the currency market as significant appreciation of the franc (on the back of heightened fiscal concerns, for example) **would likely be seen as endangering its price-stability mandate.**

Chart 5: Swiss franc vs. 10-year rates differential



Source: Pictet Wealth Management, LSEG, as of 08.07.2024

Chart 6: EUR/CHF vs. EA 10-year yield spreads



Source: Pictet Wealth Management, LSEG, as of 08.07.2024

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